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No. 90-428

In The

Supreme Court of the United States

October Term, 1990

RICHARD E. CHITWOOD and
EMMA A. CHITWOOD,

Petitioners,

v.

JOHN C. McLEMORE, TRUSTEE IN BANKRUPTCY
FOR CIRCLE W. DAIRY FARMS, et al.,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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PARTIES TO THE PROCEEDING BELOW

The petitioners in this action are Richard E. Chitwood and Emma A. Chitwood. The respondent in this action is John C. McLemore, Trustee in Bankruptcy for Circle W. Farms, Inc., Willard R. Weaver and Ivanell Weaver.

TABLE OF CONTENTS

Page

PARTIES TO THE PROCEEDING BELOW i

TABLE OF AUTHORITIES ..... iii-iv

STATEMENT OF THE CASE 1

SUMMARY OF ARGUMENT 4

REASONS FOR DENYING THE PETITION 5

CONCLUSION 14

TABLE OF AUTHORITIES

Page

CASES

Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977) 12

Chicot County Drainage District v. Baxter State Bank, 308 U.S. 371, 60 S. Ct. 317, 84 L.Ed. 329 (1940) 6

Circle v. Jim Walter Homes, Inc., 654 F.2d 688 (10th Cir. 1981) 8

County Fuel Co., Inc. v. Equitable Bank Corp., 832 F.2d 290 (4th Cir. 1987) 9

Henry v. Farmer City State Bank, 808 F.2d 1228 (7th Cir. 1986) 10

Martino v. McDonald's System, Inc., 598 F.2d 1079 (10th Cir. 1979), *cert. denied*, 444 U.S. 966 (1979) 9

Pepper v. Litton, 308 U.S. 275, 60 S.Ct. 238, 84 L.Ed. 281 (1939) 12

Robinson v. First National City Bank, 482 F.Supp. 92 (S.D.N.Y. 1979) 13

Rudell v. Comprehensive Accounting Corp., 802 F.2d 926 (7th Cir. 1986) 9

Southmark Properties v. Charles House Corp., 742 F.2d 862, 871 (5th Cir. 1984) 13

Trone v. Smith (In re Westgate-California Corp.), 642 F.2d 1174 (9th Cir. 1981) 12

Yentile v. Howland, 26 Mass. App. Ct. 214, 525 N.E.2d 689 (Mass. App. Ct. 1988) 10

TABLE OF AUTHORITIES – Continued

Page

RULES

11 U.S.C. § 510(c) 6

Bankruptcy Rule 7001 ..... 6, 11

Fed. R. Civ. P. 13(a) 4, 7, 8, 9, 14

RESTATEMENT (SECOND) JUDGMENTS § 22(2)(b) (1982), Comment (f) 11

RESTATEMENT (SECOND) JUDGMENTS § 22, Illustration 10 at page 190 (1982) 11

MISCELLANEOUS

3 *Collier on Bankruptcy* § 510.05 (1989) 6

Moore, 3 *Moore's Federal Practice* § 13.12 (2d ed. 1989) 7

Wright, Miller and Cooper, 18 *Federal Practice and Procedure* § 4414 (1981) 8

STATEMENT OF THE CASE

On September 26, 1982, the debtors Willard R. Weaver, Ivanell Weaver, and Circle W. Dairy Farms filed for bankruptcy in the United States Bankruptcy Court for the Middle District of Tennessee. On October 21, 1982, John C. McLemore was appointed as bankruptcy trustee.

Prior to September, 1982, Richard E. Chitwood and Emma A. Chitwood leased dairy cows to the Weavers. After the Weavers filed for bankruptcy, the Chitwoods directed that any cattle which they might own should be removed from the bankrupt's estate. When McLemore was appointed trustee, he went to the Weaver farm expecting to find over 1,000 head of cattle. Instead, he found approximately 40 head of cattle. McLemore began a search for the missing cattle, eventually locating 400 of them, and returned the cattle to the Weaver farm.

McLemore attempted to run the farm, but it soon became necessary to liquidate all the assets. On February 4, 1983, McLemore duly notified creditors, including the Chitwoods, that he would sell all cattle located on the debtor's farm, free and clear of all rights and claims by lien, ownership, or otherwise, and apply to the reorganization court for an order authorizing the sale. The Chitwoods, through counsel, filed and served written objections to the sale, but the objections were thereafter withdrawn.

On February 15, 1983, a hearing was held before the Honorable George C. Payne, II, who approved the trustee's application and sale. The sale was later confirmed by an order signed by the Honorable Thomas A. Wiseman, Jr., which provided, in pertinent part, that:

(1) the sale price obtained by the trustee was reasonable;

(2) all objections to the sale, with one exception not material to the issues presently before this Court had been withdrawn;

(3) the rights of all parties concerning any interest in the cattle attached to the proceeds, any claimants to promptly file pleadings to adjudicate the same; and

(4) the trustee could use the proceeds to satisfy prior borrowings from the Third National Bank.

The Chitwoods then commenced an independent diversity action against the trustee, alleging that the trustee's sale constituted a conversion of the cattle (original Count I), that the trustee had negligently cared for the cattle prior to sale (original Count II), that the cattle sold by the trustee were subject to Plaintiffs' interests as lessors (original Count III), and that a constructive trust for their benefit was imposed upon the proceeds of sale (original Count IV). The Chitwoods later amended their complaint to assert claims for money had and received in the court-approved sale (substituted Count I), unjust enrichment of the trustee's pre-sale possession of the subject cattle (substituted Count III), trespass from the trustee's action in obtaining possession of the cattle (substituted Count IV), and conversion arising out of the trustee's possession, pledge and disposition of the subject cattle (new Count V). The underlying issue on all counts of the Complaint was the ownership of cattle found on the Weaver farm. Before any recovery could be allowed in the diversity action, the Plaintiffs necessarily had to prove that they owned the cattle. If the Plaintiffs were not

owners of the cattle, then no recovery could be had. The trial began on the district court action before the District Judge Thomas A. Wiseman, Jr. on August 3, 1987. On the third day of trial, Judge Wiseman declared a mistrial and recused himself when it was discovered that he, himself, had signed the order approving the sale of the cattle in May of 1983. The case was placed upon the docket of District Judge John T. Nixon for retrial.

In the related bankruptcy proceeding, in response to the Chitwoods' objections to stipulations and an order of disbursement previously entered by the Court, the trustee asserted an equitable subordination defense to the Chitwoods' objections and also filed an independent complaint seeking equitable subordination of all claims and interests of the Chitwoods. The bankruptcy court heard evidence in this equitable subordination proceeding, and on November 25, 1987, the court entered an order which specifically found that "the cows on the Weaver farm were there, as a result of leases with various persons or were owned by Weaver and subject to duly perfected security interests of creditors. Those cattle were indiscriminately branded without any attempt being made to determine the true interest holder." The court further found that Richard Chitwood was guilty of misconduct which resulted in injury to the creditors "of the estate, both in actual expenses incurred by the estate and loss to other claimants and interest-holders whose cattle cannot be accurately identified." In reaching factual findings that the cattle on the Weaver farm, which were the subject of the sale, were owned by "various persons or by Weaver" and could not be accurately identified, the court

obviously determined the issue of ownership and adjudicated the rights of the creditors, including the Chitwoods. The United States Bankruptcy Court, therefore, reached specific findings that the ownership of the cattle could not be determined.

In April 1988, McLemore moved for summary judgment in the district court case on the grounds that the judgment and findings of the bankruptcy court in the equitable subordination adversary proceeding barred litigation of the Chitwoods' complaint under the doctrine of *res judicata*. The district court granted summary judgment and the Sixth Circuit Court of Appeals affirmed the summary judgment in a *per curiam* opinion.

SUMMARY OF ARGUMENT

Issue preclusion (collateral estoppel) bars the Chitwoods from asserting the claims made the basis of the district court action because the bankruptcy court specifically found that ownership of the cattle could not be determined. Claim preclusion bars the Chitwoods' claims because permitting the district court lawsuit to proceed would undermine the bankruptcy court's judgment and nullify or impair settled rights. Fed.R.Civ.P. 13(a)(1) does not apply to the failure to assert defenses and does not insulate a party who fails to assert a defense or counterclaim in a subsequent proceeding from the application of *res judicata* even though Rule 13(a)(1) may not require the assertion of a counterclaim where litigation of the pending claims would impair the judgment in the subsequent action or nullify settled rights.

REASONS FOR DENYING THE PETITION FOR WRIT OF CERTIORARI

I. The Trial Court Properly Granted Summary Judgment Because The Chitwoods' Claims Are Precluded By The Doctrine Of *Res Judicata*.

The Chitwoods' claims against McLemore are completely premised upon the supposed fact that McLemore sold cattle that belonged to the Chitwoods.[1] The achilles heel of petitioners' argument, however, is that the United States Bankruptcy Judge's order following the equitable subordination adversary proceeding specifically found that the cattle in question were owned by "various persons or were owned by Weaver [the debtor]" (Order at page 3) and that "Those cattle were indiscriminately branded without any attempt being made to determine the true interest holder" such that the identity of the cattle "cannot be accurately identified." (Order at page 4). Simply put, the bankruptcy court's equitable subordination order and findings preclude the Chitwoods from raising a claim in district court because allowing such a subsequent action would plainly operate to undermine the initial judgment and impair or nullify rights that were established in the equitable subordination action.

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[1] Petitioners' Brief repeatedly makes this assertion: "As amended the complaint stated five grounds for relief arising from respondent's taking of petitioners' cattle . . . " (Petitioners' Brief, page 6); " . . . the bankrupt estate had no right to petitioner's [sic] cattle" (Petitioners' Brief, page 12); "How many cattle did petitioners own?" (Petitioners' brief, pages 14-15).

The equitable subordination proceeding was an important and formal adversary proceeding under Bankruptcy Rule 7001 and 11 U.S.C. § 510(c). The whole purpose of the equitable subordination proceeding is to determine whether a creditor has engaged in misconduct which has resulted in injury to other creditors or has conferred an unfair advantage on the creditor such that subordination of the claim would not be inconsistent with the bankruptcy act. 3 *Collier on Bankruptcy* § 510.05 (1989). As Judge Payne's Bankruptcy order of November 25, 1987 clearly indicates, Richard Chitwood was an active participant in a scheme to coerce investors to invest additional funds in the Weaver operation, and to indiscriminately brand cows such that they were incapable of being identified. The court specifically found that the indiscriminate branding was done either with the approval or acquiescence of Chitwood, or at his direction. (¶ 6 Bankruptcy Judge's Order.) Under the circumstances, in order to adjudicate the rights of the creditors, equitable subordination of the Chitwood claims was deemed appropriate. To permit the Chitwoods to now obtain funds through a suit premised on ownership rights found not to exist would clearly undermine the bankruptcy court's judgment and impair the rights which were established in the equitable subordination proceeding.

The seminal decision establishing claim preclusion against a defendant where a subsequent action would undermine the force of a prior judgment or impair settled rights is *Chicot County Drainage District v. Baxter State Bank*, 308 U.S. 371, 60 S. Ct. 317, 84 L.Ed. 329 (1940). In

Chicot, a drainage district instituted a proceeding to reorganize debt pursuant to a federal law allowing municipal debt adjustment. This lawsuit resulted in a plan of readjustment and a formal decree. Later, a bank whose debt had been "readjusted" filed a separate action to recover bonds held by the drainage district. The essence of the bank's claim was that the federal law allowing the municipal debt adjustment was unconstitutional. The drainage district pleaded *res judicata* and pointed to the prior decree as a bar to the bank's claim. This Court held that *res judicata* precluded the bank's claim because the bank had notice of the proceeding of debt readjustment, had an opportunity to present objections, and yet had raised no questions concerning the validity of the act at the debt readjustment proceeding.

The legal test for determining claim preclusion is not whether the five counts of the Chitwoods' complaint are compulsory counterclaims under Fed.R.Civ.P. 13(a). Petitioners' brief fundamentally misconstrues the relationship between the compulsory counterclaim rule, F.R.Civ.P. 13(a), and *res judicata* as applied to a party in a second action who failed to interpose a claim or defense in the initial action where that party was a defendant. Rule 13(a) speaks of the necessity or compulsion of advancing claims for relief as counterclaims. The justification for compulsion is premised both upon principles of waiver and estoppel. 3 *Moore's Fed. Prac.* § 13.12 [1] at 13-52 – 55 (2d ed. 1989). If the *claim* is already the subject of another pending action, the "compulsion rule" set forth in Rule 13(a) does not apply by virtue of the express exception to the compulsory counterclaim rule set forth

in Rule 13(a)(1). The language of the Rule 13(a)(1), however, which provides that "the pleader need not state the claim if at the time the action was commenced the claim was the subject of another pending action," simply does not address whether: (1) *defenses* should or must be averred, even if the defenses are the subject of a claim in another pending action; and (2) whether pleading a counterclaim may be required by some command of law *other than* the compulsion principle set forth in Rule 13(a). Respondent submits that *res judicata* (including claim and issue preclusion) may well call for precluding the subsequent litigation of claims after a court judgment in the "second" action even though Rule 13(a) did not require the assertion of a counterclaim. The "need not" provision of Rule 13(a)(1) cannot be construed to prevent preclusion in all circumstances. As a leading treatise notes:

> "Rule 13(a), for example, does not require assertion of counterclaims that are already subjects of a pending action, yet circumstances may arise in which pursuit of the pending action should be precluded after judgment in the later-instituted action." Wright, Miller & Cooper, 18 *Fed. Prac. & Proced.* § 4414 at 110 (1981).

Numerous cases have applied issue and claim preclusion to bar claims which were not compulsory counterclaims under Fed.R.Civ.P. 13(a). In *Circle v. Jim Walter Homes, Inc.*, 654 F.2d 688 (10th Cir. 1981), home buyers brought a suit for alleged violations of the Uniform Commercial Credit Code. The court held that the suit was barred by a prior foreclosure suit and observed: "The same basic set of facts, of course, may constitute both a defense to a claim by an opposing party and the basis of a lawsuit against the party." 654 F.2d at 690. The court

ruled that principles of *res judicata*, specifically the common-law compulsory counter claim rule, precluded the subsequent suit, even though the claims for Uniform Commercial Credit Code violations in the second action were not compulsory counterclaims in connection with the prior foreclosure suit. The court determined that allowing the subsequent action to proceed would operate to undermine the initial judgment and nullify established rights. *Id.*

Other courts have reached the same result (preclusion) by applying *res judicata*, even though the formal requirements of a compulsory counterclaim were absent. *See County Fuel Co., Inc. v. Equitable Bank Corp.*, 832 F.2d 290 (4th Cir. 1987) (debtor's failure to assert a breach of contract claim to a proof of claim filed by a creditor in bankruptcy court barred a subsequent suit for breach of contract against the debtor on principles of waiver even though the breach of contract claim was not a compulsory counterclaim in the bankruptcy action); *Martino v. McDonald's System, Inc.*, 598 F.2d 1079 (10th Cir. 1979), *cert. denied*, 444 U.S. 966 (1979) (held that even though Rule 13(a) did not apply since the first action was settled prior to pleading, a franchisee was barred by failure to assert an antitrust defense in the initial suit because "successful prosecution would nullify rights established by a consent judgment in the earlier action." 598 F.2d at 1085); *Rudell v. Comprehensive Accounting Corp.*, 802 F.2d 926 (7th Cir. 1986) (held that the failure to assert a defense in a previous arbitration proceeding precluded franchisees from bringing action alleging agreement was procured by fraud. Once again, the formal requirements of Rule 13(a) did not require pleading defenses in the

initial action); *Henry v. Farmer City State Bank*, 808 F.2d 1228 (7th Cir. 1986) (failure to assert a defense barred a subsequent action. The court noted in a footnote (footnote 7) that defenses are different from a counterclaim and may be asserted even without bringing a counterclaim for affirmative relief); *Yentile v. Howland*, 26 Mass. App. Ct. 214, 525 N.E.2d 689 (Mass. App. Ct. 1988) ("The 'salutary' and well-established rules against claim-splitting . . . preclude the Yentiles from attempting in a pending or subsequent action to undermine the Land Court judgment establishing the validity of the option. They may not raise a claim in the Superior Court which was available as a defense in the Land Court action. [citing numerous authorities.]" 525 N.E.2d at 690).

Petitioners seek to apply the language in Federal Rule of Civil Procedure 13(a)(1) that compulsory counterclaims "need not" be asserted if such claims are the subject of a pending action as a blanket protection or insurance against any adverse affect which may arise from failing to interpose a claim or a defense in the second action. The rule, however, provides no such safe harbor. No statute or rule can speak or apply to every situation which conceivably may arise. Although Rule 13(a)(1) does not require setting forth an affirmative claim for relief as a compulsory counterclaim, the compulsion and waiver principles set forth in Rule 13(a) are not the limits of the *res judicata* universe and cannot be said to control how a court, such as the district court in this case, should handle a clear conflict between the judgment and findings entered by the bankruptcy court and the affirmative claims for relief brought by the Chitwoods in their district court action. To protect the

decision of the bankruptcy court and the rights established by the bankruptcy court's judgment, it was well within the equitable power of the district court to preclude the Chitwoods from bringing their claims, even though the district court lawsuit had been filed prior to the equitable subordination bankruptcy proceeding. A defendant may be precluded from bringing a claim where successful presentation of the action would nullify a judgment or would impair rights established in the initial judgment. RESTATEMENT (SECOND) JUDGMENTS § 22(2)(b) (1982), Comment (f), ("Special circumstances under which failure to interpose a counterclaim will operate as a bar.") As the RESTATEMENT (SECOND) JUDGMENTS point out in Illustration 10 to § 22:

> "A brings an action against B to acquire title to certain real estate and obtains judgment by default. B then brings an action against A to acquire title to the same property, alleging that, at the time of the first action, B had acquired title to the property by adverse possession. The action is precluded." RESTATEMENT (SECOND) JUDGMENTS § 22, Illustration 10 at page 190 (1982).

In short, *res judicata* fully applies in this case because the Chitwoods were a party to a formal adversary proceeding – the equitable subordination claim – pursuant to Bankruptcy Rule 7001 and 11 U.S.C. § 510(c). The entire purpose of the equitable subordination proceeding was to adjudicate the rights of creditors, including the Chitwoods. The issue of cattle ownership was directly addressed by the bankruptcy court's findings that, because of Chitwood's misconduct and the circumstances at the Weaver farm, the ownership of the cattle could not

be determined. In ruling in favor of the trustee at the equitable subordination proceeding, the court specifically found the necessary elements for equitable subordination:

> (1) the Claimant engaged in some type of inequitable conduct;
>
> (2) the misconduct resulted in injury to the creditors of the bankrupt or conferred an unfair advantage to the Claimant; and
>
> (3) the equitable subordination of the Claimant was not inconsistent with the provisions of the bankruptcy code." Bankruptcy Order at p. 4. *See Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977).

Bankruptcy Courts are empowered to subordinate claims of creditors where subordination will support a joint and equitable distribution of the bankrupt estate. *Pepper v. Litton*, 308 U.S. 275, 60 S.Ct. 238, 84 L.Ed. 281 (1939). The fundamental aim of equitable subordination is "to undo or offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results." *Trone v. Smith (In re Westgate-California Corp.)*, 642 F.2d 1174, 1177 (9th Cir. 1981). It is clear by the bankruptcy judge's findings of fact and conclusions of law that a good part of the inequitable conduct exhibited by the Chitwoods was the role Mr. Chitwood played in the indiscriminate branding of the cattle. The indiscriminate branding was done without a determination of the true interest holder, thus making it impossible to determine the owner(s) of the cattle. The cattle were branded with the Chitwood

brand (REC) without regard to whether the cattle truly belonged to Chitwood. (¶ 6 Bankruptcy Judge's Order).

The proper time to determine the ownership of the cattle was during the adversarial proceeding regarding the trustee's equitable subordination claim against the Chitwoods. Mr. Chitwood, however, although represented by counsel, chose not to appear. Also, no appeal was taken from the judge's order. The reorganization court's order thus bars the Chitwoods from any remedy based upon ownership of the cattle. *Southmark Properties v. Charles House Corp.*, 742 F.2d 862, 871 (5th Cir. 1984) (prior judgment concludes all claims arising out of "common nucleus of operative facts"); *Robinson v. First National City Bank*, 482 F.Supp 92 (S.D.N.Y. 1979), (court held that since neither of the parties appealed the reorganization court's approval of compromise and settlement of securities law and fraud claims, the bankruptcy adjudication was considered the final judgment of the merits of those claims, and thus, plaintiff's settlement in the reorganization proceedings barred relitigation of those claims before the district court).

Issue preclusion, or the principle of collateral estoppel, clearly bars the Chitwoods from asserting the claims made the basis of the district court action. As Judge Nixon's summary judgment memorandum makes clear, the issue of cattle ownership was in dispute at the bankruptcy proceeding and Judge Payne specifically found that the cattle on the farm had been indiscriminately branded without any attempt being made to determine the true interest owner. The court further found that the

cattle on the Weaver farm were owned by various persons, including the Weavers, and that specific ownership simply could not be determined.

The Chitwoods' claims are predicated upon the same facts which gave rise to the trustee's equitable subordination claim. The central issue in both cases was ownership and rights to particular cattle. That issue was decided by the bankruptcy court adversely to the Chitwoods. Relitigation would only undermine the bankruptcy court judgment and disturb settled rights in contravention of the law of collateral estoppel.

CONCLUSION

The Chitwoods were unsuccessful in obtaining money from the bankruptcy estate through the bankruptcy court. In part, this was because of their own misconduct in indiscriminate branding of cattle which precluded proper identification of ownership interests. The Chitwoods must not now be allowed to assert claims predicated upon grounds which they have, or could have, interposed in response to the complaint filed regarding the subordination of their interest in the Weaver estate. To do so would violate the doctrine of *res judicata*. Although Fed.R.Civ.P. 13(a)(1) did not mandate that the Chitwoods file counterclaims in the equitable subordination action, the bankruptcy court's findings and judgment now bar the Chitwoods' claims.

Respondent respectfully requests that this Court deny the petition for certiorari.

Respectfully submitted,

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